RECENT DEVELOPMENTS IN OFFSHORE AND DOMESTIC ASSET PROTECTION PLANNING

Presented to Mid-Atlantic Members and Guests

Society of Trust and Estate Practitioners (STEP)

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For Comprehensive Treatment of General Topic of Domestic and Foreign Asset Protection Trust and Asset Protection Planning Generally, see on www.fredtansill.com under Articles, Speeches, Outlines.

- Asset Protection Trusts: Non-Tax Issues; Presented October 11, 2013 ALI-ABA Course on International Trust and Estate Planning; Boston, Massachusetts.

- Asset Protection Planning: Planning Strategies for the Protection of Family Assets from Claims of Creditors and Other Predators; Presented June, 2010 ALI- ABA Course on Estate Planning in Depth; Madison, Wisconsin.

IMPACT OF FATCA ON OFFSHORE ASSET PROTECTION TRUST, CORPORATE FOUNDATION AND OTHER ENTITY-BASED ARRANGEMENTS.

Because of the burden and cost of reporting, offshore financial institutions will be more reluctant to help, will charge higher fees, will only handle larger accounts.

And will rigorously insist on and verify U.S. tax transparency and compliance.

IMPACT OF FATCA ON OFFSHORE ASSET PROTECTION TRUSTS

Per Brian Balleine, Managing Director, Butterfield Trust (Cayman) Limited - -

"Trusts are no longer economical for the average wealthy client, but require assets of say $10 - $20 M as a minimum, and minimum fees of $15,000 per annum."

IMPACT OF FATCA ON OFFSHORE ASSET PROTECTION TRUSTS…cont…

Citing increasing costs from FATCA, industry best practices, compliance reviews, performance measurement, detailed accounting.

"The complexity of the industry has meant that more qualified and higher paid personnel are needed to run the trust business."

BASIC TAXATION OF DOMESTIC AND OFFSHORE ASSET PROTECTION TRUSTS

Income Tax

- Offshore trusts are normally designed so that no U.S. Court will exercise primary jurisdiction over the administration, and so that there are no U.S. trustees, or at least none with authority to control all substantial decisions of the trust (those being reserved to offshore trustee), and therefore such trusts are "foreign" for U.S. tax purposes. IRC §7701(a)(30)(E) and (31)(B)

- Foreign Trusts with U.S. beneficiaries are grantor trusts by virtue of IRC §679. The Settlor reports the income and pays the tax.

BASIC TAXATION OF DOMESTIC AND OFFSHORE ASSET PROTECTION TRUSTS…cont…

Domestic Asset Protection Trusts are generally "defective" grantor trusts because they are held for the benefit of the settlor (IRC §677) or they are otherwise drafted to fall within the grantor trusts rules of (§§671-678). The Settlor reports the income and pays the tax.

BASIC TAXATION OF DOMESTIC AND OFFSHORE ASSET PROTECTION TRUSTS…cont…

Estate and Gift Tax

- Offshore Asset Protection Trusts for U.S. residents are almost always drafted to create incomplete gifts, so that the estate tax planning would look like that found in a U.S. revocable trust, and would coordinate with the client's domestic estate planning.
- The same is generally true of domestic asset protection trusts.

BASIC TAXATION OF DOMESTIC AND OFFSHORE ASSET PROTECTION TRUSTS…cont…

Holy Grail

- There is a school of thought that it is possible to establish a self-settled spendthrift trust of which the settlor is a potential beneficiary to which transfers are completed gifts, outside of the settlor's estate, protected from the settlor's creditors, but available to the settlor in an "emergency."
- I am very skeptical that all of these objectives may be obtained in one trust.

Offshore Trust to Avoid SEC Disclosure?

SEC v. Wyly (USDC, S.D.NY. 2014)

Defendant brothers employed a "labyrinthine" system of offshore trusts to conceal stock trades in 4 companies on whose boards they sat, most notably Sterling Software, netting the trust over $550 million of profits from what was arguably undisclosed insider trading. They used more than a dozen trusts and over 40 different entities all in the Isle of Man to disguise their activities.

Key issue for the jury: Did the Wylys control the securities and their sale or did the trustees have full control and exercise independent discretionary authority?

INCORPORATE ASSET PROTECTION PLANNING IN EVERYDAY ESTATE PLANNING

Think of Protecting Testamentary Trusts from Creditors of the Beneficiary

Credit-Shelter/Bypass Trust

- all distributions of income and principal at the complete discretion of an independent trustee or co-trustee
- beneficiary should not be sole trustee with an ascertainable standard: beneficiary's creditors could litigate whether the standard was met
- no 5 + 5 power
- permit distributions to or for the benefit of the beneficiary, so he may be supported without attachable funds coming into his hands

INCORPORATE ASSET PROTECTION PLANNING IN EVERYDAY ESTATE PLANNING

Marital Trust

- all distributions of principal at the complete discretion of an independent trustee or co-trustee
- spouse should not be sole trustee with an ascertainable standard
- spouse should not have 5 + 5 power
- permit distributions of income or principal to be made to or for the benefit of the spouse
- if spouse has creditors, very little income could be produced

WINDSOR, SAME SEX MARRIAGE AND ASSET PROTECTION

- In Windsor v. U.S., 133, S Ct. 2675 (2013), the Supreme Court permitted states to define "marriage," in effect to permit (or not) same-sex marriage. As of this month, 17 states plus D.C. have recognized same-sex marriage.
- Many domestic asset protection techniques are products of state law.

WINDSOR, SAME-SEX MARRIAGE…cont…

- Tenancy by the Entirety property, for example, in Virginia is absolutely impregnable to claims of creditors who have claims against only one spouse. This appears to also be the rule in D.C., Maryland, and other states.

- In Virginia and many other states, intangible personal property -- cash, securities, LLC and limited partnership and shareholding interests -- may be held as tenants by the entirety.

WINDSOR, SAME-SEX MARRIAGE…cont…

- But Virginia does not recognize same-sex marriage, so same-sex couples in Virginia may not avail themselves of the protections of tenancy by the entirety as a form of property title. In Maryland and D.C., which recognize same-sex marriage/tenancy by the entireties between same-sex couples as to realty and personalty, this asset protection advantage should be available.

- Moreover, Virginia law expressly prohibits same-sex couples from entering into enforceable pre- and post-nuptial agreements.

WINDSOR, SAME-SEX MARRIAGE…cont…

Code of Virginia Section 20-45.3 Civil Unions between persons of same sex.

"A civil union, partnership contract or other arrangement between persons of the same sex purporting to bestow the privileges or obligations of marriage is prohibited. Any such civil union, partnership contract or other arrangement entered into by persons of the same sex in another state or jurisdiction shall be void in all respects in Virginia and any contractual rights created thereby shall be void and unenforceable."

WINDSOR, SAME-SEX MARRIAGE…cont…

Our firm's experience is that many childless couples want to leave everything outright to the other, subject to a marital agreement that the survivor will leave some of the survivor's estate to the family or favorite charities of the first to die. That does not work with same-sex couples in Virginia.

Some sort of trust arrangement for the survivor with the remainder to the family of the predeceased would have to be used instead.

WINDSOR, SAME-SEX MARRIAGE…cont…

The federal government, including the IRS, have announced that federal law -- e.g., re: spousal rights in ERISA plans -- will be enforced for same-sex couples validly married under state law.

This provides important property rights and asset protection, as in Patterson v. Shumate, 112.S.Ct.2242 (1992), the U.S. Supreme Court held that creditors of a participant in an ERISA plan (401(k)s, not IRAs) have no rights against the assets of such plans.

WINDSOR, SAME-SEX MARRIAGE…cont…

A partner of a same-sex couple domiciled in Virginia has no right to be named as primary beneficiary of an ERISA plan, as a spouse would, unless validly married under the laws of another jurisdiction. The IRS will look to the "state of celebration rule" to determine spousal rights, even if the couple is domiciled in a state which does not recognize same-sex marriage.

ULTIMATE PREDATOR: SPOUSE

- A shockingly high percentage of asset protection consultations are focused on the client's desire to protect assets from a prospective or existing spouse.
- Because of the Ethical Rules on Joint Representation
    - How can you help one hide/protect assets from the other if you represent both?

ULTIMATE PREDATOR: SPOUSE

At the inception of such a representation of a married client whom you are meeting alone, avoid representing the other spouse.

If you already have represented both, forget it! Do not get involved.

ULTIMATE PREDATOR: SPOUSE
Florida Case

- Interesting recent case in Florida, Berlinger v. Casselberry, a 2013 case which permitted an ex-spouse to garnish the distributions of a discretionary spendthrift trust established by a third party (presumably husband's parents) for the benefit of her ex-spouse in order to satisfy unmet alimony obligations.

ULTIMATE PREDATOR: SPOUSE Solution

- Solution: Barry Nelson, a leading Florida asset protection attorney, recommends establishing spend-thrift trusts under the laws of Alaska, Delaware, Nevada or North Dakota, whose laws would protect the trust in these circumstances.
- Can an existing trust be moved to one of these jurisdictions to avoid the Berlinger result?
- How late in the game can you effect such a move?

Is It A Fraudulent Conveyance When A Married Party With Separate Assets Transfers Them To A Divorce-Protected Structure?

- If community property, even if in the name of one spouse, maybe. There are some bad cases.
- In a non-community property jurisdiction, where spouse's rights in other spouse's property accumulated from earnings during marriage is inchoate, probably not, at least per se.

Portability and Spousal Claims in Divorce

- With portability we have an excuse not to blunder into a recommendation of "equalizing the estate" which leaves the wealthier party with no leverage in property settlement negotiations.
- In non-community property states, "equitable distribution" of couple's assets accumulated during marriage may not be 50%-50%, and parties may negotiate a very different number considering alimony, child support, testamentary obligations such as life insurance, etc.

Pre- and Post- Nuptial Agreements Are Hugely Important In Limiting Spousal Claims In Divorce Where There Is A Large Discrepancy In Income or Net-Worth

- General Requirements for Enforceability:
  - Separate Counsel
  - Full Reciprocal Disclosure of Balance Sheet and Income Statement

Typical Important Objectives:

- Limit or Eliminate Alimony Claims
- Eliminate spousal rights to take ERISA plans
- Limit obligations at death to an amount less than the typical one-third mandatory spousal share
- Clarify what is and what is not marital (joint) property to be divided 50-50 at divorce, especially untitled tangibles. See the attached sample agreement which some lawyers recommend.

APPENDIX A

Memorandum of Intent

Marital/Non-Marital Property Agreement

We, Gregory E. Jones and Wendy L. Jones, husband and wife, have consulted with legal counsel to prepare our respective estate plans.

Part of the consultation addressed the estate tax benefits which may arise from severing joint tenancies, changing beneficiary designations and transferring various assets, so that the first of us to die may more strategically use the estate and generation-skipping transfer tax free amount then available, or maximize basis step up opportunities.

The consultation also made us aware that absent an agreement between us, some changes which may be beneficial for estate tax purposes may be argued to alter our respective rights in the event of dissolution of our marriage.

This Agreement is executed to document our intent that all changes made now or in the future to maximize potential estate tax savings or to avoid probate, specifically including (but not limited to) title to [our primary residence,] shall not alter our respective rights upon dissolution of marriage.

Assets and benefits acquired as marital property during our marriage shall remain as marital property without regard to which of us may be in title, and without regard to transfers between us or to or from trusts or other entities controlled by either of us. Similarly, assets and benefits currently held or acquired in the future as non-marital property shall remain as non-marital property without regard to which of us may be in title, and without regard to similar transfers.

Executed at _____, Illinois, on _____, _____, _____.

_____ _____

Gregory E. Jones Wendy L. Jones

231947v7

What You Cannot Accomplish:

- Limit Child Support for any children born of the marriage.

Assets Held As Joint Tenants Are Probably Not Protected From Creditors of One Spouse

- In a 2014 4th Circuit Case, Romano v. Olshen, the Court reversed a Florida court's ruling permitting creditors of an incapacitated joint tenant of a 2-signature bank account to be paid from the survivorship account after his death, not withstanding the objections of the surviving spouse.

- The court determined that the account was not a tenants by the entirety account -- normally that has to be express.

Assets Held As Joint Tenants Are Probably Not Protected From Creditors of One Spouse…cont…

The creditor in this case was the court appointed guardian with a claim for guardianship fees and expenses, including legal fees associated with the guardianship, so the facts were very sympathetic. And the ward had commenced divorce proceedings against the co-owner before he died.

- Incredibly, the 4th Circuit expressly recommended that the Florida legislature amend the statute and allow access to even tenancy by the entirety accounts for necessary expenses of a ward even when the spouse does not agree.

- In Florida a revocable trust could not be invaded in similar circumstances. I doubt if a revocable trust would be protective in these circumstances in D.C., Maryland or Virginia.

Eight DAPT Cases Over Last Two Years, None Recognized DAPT As Effective

- Per Professor Jeff Pennell of Emory Law, a very distinguished commentator, every one of the eight cases from the last two years which he reviewed in which clients sought by using a DAPT to protect assets from creditors failed, because

  - Fraudulent Conveyance or

  - 10-year bankruptcy clawback

In one case the attorney assisting the fraudulent conveyance was disbarred for two years. Matter of Morris, California, 2013.

Eight DAPT Cases Over Last Two Years, None Recognized DAPT As Effective…cont…

My Favorite: Rush University Medical Center v. Sessions, Illinois, 2012.

Benefactor made large charitable pledge to hospital. Then checked in, was misdiagnosed, mistreated and became terminal. He sought to void pledge by transferring LLCs holding Illinois real estate to offshore DAPT in Cook Islands. Illinois court invoked common law principal that self-settled spend thrift trusts are ineffective. (Illinois does not recognize DAPTs.)

Eight DAPT Cases Over Last Two Years, None Recognized DAPT As Effective…cont…

For a wonderful chart comparing and contrasting the DAPT statutes of all 15 DAPT jurisdictions, prepared by David Shaftel, an ACTEC fellow in Alaska, with reporters in each of the 15 states, see my offshore trust outline on my website cited on the first slide, Exhibit B.

•MULTI-MEMBER LLCs AND ASSET PROTECTION

- Ownership interest in a multi-member LLC (or partnership) enjoys uniquely protected status under the laws of most states (California is one possible exception) and under Federal bankruptcy.

- Whereas cash, securities, real estate, closely-held stock owned by a debtor in his own name may be attached by creditors with a judgment, such LLC interests may not be.

MULTI-MEMBER LLCs AND ASSET PROTECTION…cont…

- Generally under state law the only remedy of a creditor against such an interest in a charging order which, if sought and obtained from a court, would direct the manager of the LLC or partnership, if funds are to be distributed to the debtor, to instead distribute them to the creditor.

- But if the entity is closely-held within a family group, the charging order may be defeated by retaining rather than distributing income and assets.

- A creditor may NOT become a member or partner.

MULTI-MEMBER LLCs AND ASSET PROTECTION…cont…

As a result, interests in LLCs and partnerships are "ugly" assets from a creditor's point of view.

To make charging orders even less appealing, at least some believe that a creditor with a charging order but not receiving any income would receive the tax form K-1 from the entity for the interest subject to the charging order, and be required to pay tax on the phantom income.

MULTI-MEMBER LLCs AND ASSET PROTECTION…cont…

- LLCs (and partnerships) may, of course, hold assets otherwise not protected: real estate, cash and securities, stocks.

- Scholars have identified the statutes of 7 states as "Magnificent Seven" the most protected from creditors, including Delaware, Virginia, New Jersey, and Florida.

MULTI-MEMBER LLCs AND ASSET PROTECTION…cont…

Other reasons Family LLCs are so popular:

- You can give away assets for transfer tax purposes but retain control (as Manager) regardless of how small an ownership interest is retained.
- You may discount the fractional interest gift by 20-30% for lack of control and marketability, etc.
- The interest retained by the donor may be discounted on the donor's estate tax return by 20-30%.

May High School Tuition Payments Be Fraudulent Conveyances and Recovered in the Parent's Bankruptcy?

- No! In Re Akanmu 502 B.R. 124 (Bankr. EDNY 2013). Trustee in bankruptcy sought to recover tuition paid to two Catholic high schools. The Court cited the obligation of support of minor children under state law, and held that the parents were free to discharge this obligation by using private education rather than public.

- The Court acknowledged the line of cases holding that payment of college tuition for a child 18 or older may be a fraudulent conveyance because such children are not minors, and are not entitled to parental support.